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REGULATING THE INTERNATIONAL CAPITAL MARKETS: A NEW WORLD AND A NEW PERSPECTIVE

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REGULATING THE INTERNATIONAL CAPITAL MARKETS:
A NEW WORLD AND A NEW PERSPECTIVE

Ladies and gentlemen, these are historic times for the world's capital markets. London is sorting itself out in the wake of Big Bang, Paris is preparing for *Le Petit Bang*, and all of us are still reeling from the Biggest Bang, the precipitous worldwide equity price declines that occurred during the last half of October.

These historic times are also trying times for economic policymakers and securities regulators. The world wants to know why prices fell as far and as fast as they did. The world wants also to know whether some or all of this decline could have been avoided through the application of different economic or regulatory policies. The pressure on the world's economic policymakers and securities regulators to find explanations and craft viable responses has never been greater. The need for confidence in the world's financial markets has never been stronger. The stress on those in positions of economic responsibility has never been more clear.

Times of great change, however, are also occasions of great opportunity. Opportunities are greatest for economic policymakers who have the ability to influence deficits, interest rates, and currency values. If these policymakers respond properly to the messages sent by the market decline, the world's economic system may well emerge far stronger as a result of the market's sharp price fall.

Opportunities are also great for securities regulators. Securities regulators do not cause prices to rise or decline. Instead, securities regulators define the rules by which markets operate and control the process through which buyers and sellers determine equilibrium values. Although the influence of securities regulators on securities price levels may be modest in comparison with pressures brought to bear by Presidents, Prime Ministers, legislators, central banks, and others, securities regulators are hardly irrelevant. They have an important role in assuring that market prices are honest in that they accurately reflect the interaction of supply and demand, and are not manipulated to send price signals that are false or misleading.

Securities regulators must now decide how to respond to the remarkable events of the past month. Some observers suggest that the regulatory system has worked reasonably well and recommend that few if any changes be made in response to recent sharp price declines. These observers claim that prices would have settled at lower, long-term equilibrium levels regardless of changes in the regulatory regime. Trading halts, price limits, and prohibitions on program trading may alter the trajectory of a decline, but the decline would have occurred in any event. As support for their position this group can point to the experience of the Hong Kong market, which shut down for the week of October 19 only to watch prices drop by more than 30% when it reopened. From

this experience it can be argued that many popularly discussed forms of regulatory intervention would have been ineffective or even harmful.

Other observers take a different approach and point to the October price decline as evidence of serious flaws in the world's regulatory regimes. They argue that tighter controls on the market could have prevented the rapid decompression of stock prices--at least slowing the fall and perhaps even altering the final resting place. They also argue that tighter controls could perhaps have deterred stock prices from reaching levels they now view, in hindsight, as having been unsustainable. To these observers, it seems that substantial international regulatory intervention may be necessary or appropriate, complete with the creation of an international securities regulatory agency and the adoption of uniform rules for worldwide trading.

In my address tonight, I will side neither with proponents of aggressive regulation nor with those who would leave the markets, as currently regulated, well enough alone. Instead, I will explore some of the implications of internationalization for the world's securities regulators and develop three themes that are, I believe, valuable regardless of where one falls on the spectrum between international regulation and the status quo. All three themes suggest that it may be time to adopt a new and different perspective about the operation of the world's securities markets. In

considering these three themes it may be useful to recall the words of Louis Brandeis, a Justice of the United States Supreme Court, who observed that "if we would guide by the light of reason, we must let our minds be bold."[1]

If we truly let our minds be bold, we would recognize that the challenges that confront securities regulators today cannot be addressed through traditional modes of analysis. If we would let our minds be bold we would recognize that the assumptions on which many regulatory regimes are based--assumptions crafted largely during the 1930's--are no longer true. The time has come to challenge traditional modes of thinking. The events of the last month challenge us to explore evolutionary proposals that rely on a perspective different from the one often used in the past, at least by American securities regulators. Indeed, the proposals that I present this evening may have to be incorporated in the thinking of regulators worldwide if we are to emerge stronger from our recent crises and if we are to avoid a harmful regression into counterproductive, isolationist modes of regulation.

The first theme I will develop relates to the way regulators analyze the world's securities markets. An uninformed regulator is a dangerous regulator. In order to regulate properly, regulators must understand the complex

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[1]New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

operation of today's markets. They must be able to assess accurately both the beneficial and harmful consequences that can follow from the adoption of any regulation.

In other words, regulators must be able to diagnose before they prescribe. They must also be sensitive to the risk that the side effects of proposed regulations may be more damaging than the proposed cure. Diagnosis in today's markets is no easy task because today's markets are far more sophisticated than they were even five years ago. Regulators uncomfortable with the intricacies of options pricing models and futures trading strategies will be unable to do a competent job. Technology and mathematical analyses that, five short years ago, were found only in the halls of academe are now commonplace on the market floor. Regulators cannot regulate that which they do not understand. And just as the markets have generated a new breed of traders who ply new and sophisticated strategies, governments will also have to generate a new breed of regulator comfortable with the intricacies of Black-Scholes pricing models, portfolio insurance, and index arbitrage.

The second theme I will develop suggests that regulators will, in the not too distant future, have to question the very *raison d'etre* of securities regulation. In today's highly internationalized marketplaces it is clear that no nation's regulators control the capital flows that determine equilibrium interest rates, currency values, and equities

prices at the margin of the market. Therefore, regulators will gradually realize that, they have only limited power to impose their views on a huge and virtually stateless pool of capital that is perpetually seeking the best available risk-adjusted rate of return. Rules that impose costs in excess of benefits will, at the margin, repel international capital and transactions. In contrast, rules that generate the best available benefit-cost ratios will, at the margin, attract international capital and transactions.

Accordingly, the view may emerge that regulation in today's capital markets acts as a form of quality control that governs trading and disclosure in the regulator's market only. Regulators cannot force international investors to accept their regulations because investors with mobile capital can choose among markets offering a range of quality-price combinations. International investors will select the market with the best risk-adjusted rate of return, taking into account the quality-price tradeoff created by local securities regulation, among many other factors. Thus, it may be useful for regulators to think of themselves as business people whose job it is to establish optimal quality-price levels. An optimal quality-price level will make a home market as attractive as possible to highly mobile internationalized capital--understanding, all the while, that efforts to accommodate international capital may have to be reconciled

with domestic pressures that often run in a countervailing direction.

The third theme involves the need for international cooperation in the enforcement of securities laws. As recent events demonstrate, each of us is at each other's mercy when it comes to securities laws violations. Britain's laws can be violated in British markets by British subjects located in New York. Similarly, U.S. laws can be violated in U.S. markets by U.S. citizens located in London. The permutations that can lead to transnational abuse increase rapidly with the number of jurisdictions involved in financial transactions.

In this environment, it is incumbent upon all market participants who value the integrity of their domestic regulatory regimes to strive toward principles of cooperation and comity that assure that no jurisdiction acts as a haven for those who would violate the laws of a trading partner. We can and should achieve this important degree of cooperation without resort to regulatory imperialism in which one country seeks to impose its regulatory philosophy on others. We can also achieve this goal without the need for broad multi-national agreements on substantive rules governing the regulation of international markets--agreements that may be quite difficult to reach. Accordingly, mutual enforcement assistance based on principles of comity, untainted by the desire to impose regulatory philosophies on trading partners,

may be an important first step in achieving meaningful international regulatory cooperation.

There is perhaps no better way to introduce my first proposition--that the new breed of sophisticated traders requires a new breed of equally sophisticated regulators--than by recounting the events of October 19 and discussing some of the subtleties of analysis that will have to be considered to determine how and why markets fell so far and so fast.

I. October 19, 1987

It is difficult to overstate the potential implications of the events surrounding Monday, October 19, 1987. On that day, all the world's equities markets suffered a rapid and dramatic price decline. The United States' Dow Jones Industrial Average dropped by 508 points, or roughly 22 percent. London's Financial Times 100 index lost 500 points during trading on the 19th and 20th--the days that bracket New York's decline--or 22 percent. In Japan, the Nikkei 225 index dropped 4,836 points on the day following New York's decline, or about 14.9 percent, a decline that was, in many cases, at or close to the maximum percentage daily price change permitted for individual stocks on the Tokyo Stock Exchange. After October 19, anyone who believes that the world's capital markets are not inextricably linked deserves, as we say in America, to have his head examined.

The rapid declines of October 19 and of the following week were achieved on historic volume. More than 600 million shares changed hands in a single day on the New York Stock Exchange, and for the week, the exchange processed trading of more than two billion shares. More shares were traded in a single week in 1987 than in all of 1968 on the New York Stock Exchange. The volume of trading was so large, and the strain on brokerage firm back offices was so great, that the New York Stock Exchange found it necessary to close two hours early for an extended period so that back offices could keep pace with the crushing flow of work.

Remarkably, for the ten days after trading surged, the job got done promptly and accurately. Whenever volume increases so rapidly and unexpectedly, fears arise that the system will crumble under the load. Will trades be lost? What will happen to unmatched trades? Will brokers attempt to break trades that went against them during periods of almost chaotic activity?

The worst did not happen. Indeed, as of the date of this text, it appears that the U.S. brokerage industry has weathered the storm quite well. Only a small number of brokerages failed, and these were primarily smaller institutions. Larger brokers have certainly suffered losses, but their capital positions all looked quite solid, especially in light of the evaporation of equity values over the preceding weeks. Customers have complaints about their

handling of their orders but, viewed in the aggregate and in light of the tremendous volatility and volume encountered during that period, the remarkable fact may be not that there were so many complaints, but that there have not been more complaints.

At this point, everyone wants to know why the decline happened. There is no shortage of theories to explain the events of Monday, October 19. The decline has been blamed, among other things, on the U.S. trade and budget deficits, changes in U.S. tax policy, interest rates, currency levels, inflation, tensions in the Persian Gulf, and the emergence of program trading. Indeed, I suspect that I have heard 508 theories to explain the 508 points lost in New York on October 19.

While all of these theories will be thoroughly explored in studies to be conducted by a special Presidential task force and by the Securities and Exchange Commission, at this point two facts about the decline appear clear. First, speculation about the causes of the decline is far more advanced than understanding of those causes. Second, to achieve even a partial understanding of the causes of the decline, regulators will have to master the intricacies of complex markets and apply a broad range of analytic techniques.

To illustrate the intellectual challenges confronting regulators trying to unravel the events of October 19,

consider for a moment the popular allegation that portfolio insurance was a major factor contributing to the market's decline. How can a regulator determine whether that charge is true or false? And, if the charge is true, what can a regulator do about it?

As an initial matter, a regulator must understand what portfolio insurance is. Although portfolio insurance is often described in somewhat mysterious terms as the arcane product of some computer programmer's imagination, the basic idea underlying portfolio insurance is nothing new. In fact, at its root, portfolio insurance is nothing more than a set of systematic "stop-loss" rules that use the futures markets instead of the stock market in an attempt to limit a shareholder's risk of loss.

To illustrate this point, consider an investor with a million dollar stock portfolio when the Dow Jones average is at 2,500 points. Suppose this investor wants to cushion his downside risk so that he is sure to be out of the market if it ever drops to 2,200 points. This investor could follow a strategy that has him sell one-third of his portfolio whenever the Dow drops 100 points from its level of 2,500. So, if the Dow drops 100 points to 2,400, the investor sells a third of his portfolio. If it drops to 2,300 points, he sells another third of his portfolio. And, if it drops another 100 points to 2,200, he sells the last third of his portfolio and he is totally out of the market as it hits 2,200. In a very

rudimentary form, this type of "stop-loss" strategy constitutes a dynamic hedge that is similar to portfolio insurance.

Modern portfolio insurance, however, operates in the futures markets rather than the stock market. Portfolio insurers prefer the futures market because, under normal circumstances, the futures market provides substantial liquidity at low transaction cost. A portfolio insurance strategy might, for example, signal the client to sell futures contracts to offset his long stock position when the market declines to 2,400, 2,300, and then 2,200 points. The client would later unwind his offsetting futures and stock positions by purchasing a futures contract while selling his equity position directly in the stock exchange.

If sales by investors employing portfolio insurance strategies depress futures prices to a level where futures trade sufficiently below the value of the equivalent stock index, then there is a second group of traders, popularly known as index arbitrageurs, who act to bring the stock and futures prices back in line. Index arbitrageurs simply buy low in one market and sell high in another. If the future is too low relative to the stock, the arbitrageur will buy the future and sell the stock. If the future is too high relative to the stock, the arbitrageur will buy the stock and sell the future. The purpose of this trading is to profit from price

discrepancies between the two markets and to move the pricing in the two markets closer together.

One popular story told about October 19 in the United States is the "meltdown" scenario. According to the "meltdown" scenario, portfolio insurance fueled the market's decline by triggering a tremendous amount of selling volume into the futures markets. This selling pressure drove the futures price to a discount relative to the stock index and triggered index arbitrage through which arbitrageurs bought futures and sold stocks, thereby driving the stock market down even further. According to the meltdown scenario, the lower stock prices resulting from the initial portfolio insurance selling and arbitrage then triggered more portfolio insurance selling in the futures market, and the cycle repeated itself while the market plummeted by about 22 percent.

Now, how can we tell if this story is true and whether portfolio insurance contributed to the decline? As a first step, it is clear that data can be gathered describing the timing and volume of portfolio insurance-related trading. But even if the data show significant selling by portfolio insurers, and significant index arbitrage activity, does it follow that portfolio insurance caused or contributed to the decline? Not necessarily, because, to answer the question properly, one must consider what would have happened in the markets if portfolio insurance did not exist.

Had there been no portfolio insurance, it is entirely possible that investors who sold futures contracts on the October 19 would instead have sold stocks directly on the floor of the exchange in order to reduce their exposure to the decline. Recall that portfolio insurance is, after all, little different from the entry of a series of "stop-loss" orders. Just as a series of futures sales can cause stock prices to decline, an equivalent series of executions of stop-loss orders can also cause prices to decline.

Indeed, one can replicate the entire "market meltdown" scenario without any reliance on the futures markets at all. All you need do is imagine a market where many investors are, for whatever reason, concerned that the market is overpriced. These investors try to protect themselves either by entering stop-loss orders or by quickly entering sell orders when they see the market decline. If the market declines as a result of these sell orders, then further sell orders may be attracted as other investors try to limit their losses at lower trigger points, *ad infinitum*. I tell this story not to suggest that it is true--rather, I tell it to illustrate the fact that even if one believes in meltdown scenarios, the elimination of futures trading or portfolio insurance does not eliminate the hypothetical possibility of a "meltdown," if one believes in "meltdowns" at all.

Thus, we are led to the observation that there are often low tech substitutes for the high tech world of program

trading. These low tech substitutes may be less precise and more expensive, but they can operate with much the same effect and perhaps even at similar speeds. After all, the markets crashed in 1929 and we know we can't blame that decline on program trading. Markets also declined rapidly in London and Tokyo when portfolio insurance and index arbitrage are nowhere nearly as prevalent as they are in the United States. Accordingly, even if futures markets didn't exist, and even if portfolio insurance as we know it today were banned, the markets could have experienced precisely the same decline that they suffered on October 19.

Further, even if one wanted to outlaw portfolio insurance, it is not clear that a regulation could rationally achieve that goal. After all, portfolio insurance is essentially a way of thinking. It is a market strategy, it is not a tangible good that can be burned or quarantined. Governments can try to make portfolio insurance more difficult or expensive but governments cannot enact statutes or write regulations that change the way investors think. Not surprisingly, statutes and regulations that set out to do the impossible are doomed to fail.

II. Regulation as Quality Competition

Understanding the technical dynamics of our new markets is but a first step. The new dynamics must also be appreciated in light of the extraordinary degree of

internationalization in today's marketplace. The price declines of October demonstrate, in the most graphic terms imaginable, the extent to which all the world's capital markets are really part of a single international market. The decline thereby underscores the need for pro-competitive evolution in the worldwide technology of financial regulation, combined with enlightened cooperation among the world's securities regulators.

At the margin, where international capital flows determine equilibrium prices, there are no separate London, Tokyo, or New York markets. There is instead a single international market that manifests itself at different times in different places. This reality is reflected at the macroeconomic level where finance ministers of the world's economic powers understand the need for coordinated action, although they are not always successful in coordinating their actions. This reality is equally powerful at the microeconomic level, where securities regulators operate, and where each nation must understand that there are serious limits on its ability to control the pricing or flow of international capital.

The consequences of internationalization are fundamental for securities regulators. In particular, internationalization often means that regulation can have major, unintended consequences. Internationalization means that regulations can be avoided even by relatively small and unsophisticated

investors, and further suggests that the premises upon which many regulatory regimes are currently based are dangerously false. In this regard, it is useful to consider the United States' regulatory structure as a case in point.

The United States' regulatory structure was crafted in the 1930's, at a time when international trade and international capital flows were a mere trickle. The government, in this autarkic environment, gave little consideration to the possibility that domestic capital market regulation could drive transactions offshore. The government also did not actively consider the possibility that its regulations would deter foreign transactions from entering the U.S. After all, there was precious little capital to attract or repel. Thus, during the Depression, the U.S. could regulate as though it were a closed economy.

The days of closed national economies are, fortunately, long behind us. Protectionist measures may well have been a leading contributor to the Great Depression, but even if one rejects that explanation of the Depression, it is clear that prosperity and international trade are inexorably linked. We cannot move back to a world in which the closed economy assumptions underlying the U.S. securities laws are true without sacrificing the prosperity we have today. That, of course, is too high and irrational a price to pay for the cold comfort of unassailable regulation.

Nonetheless, the United States continues to pay the price of having a regulatory structure built on a fundamentally false assumption. The consequences of this situation can be quite paradoxical and self defeating. For example, the Glass-Steagall Act, adopted in 1933, forbids commercial banks from engaging in investment banking activity. The Act, however, is effective only in the United States, and U.S. banks have been able to avoid many of Glass-Steagall's restrictions by opening branches in London and elsewhere. In an international environment, Glass-Steagall's primary effect may therefore be to drive banking business away from New York and toward London, rather than to prevent U.S. banks from engaging in certain activities that Congress once sought to prohibit.

Interestingly, the closed capital market assumption can be as false for the smallest U.S. investor as is it for the most sophisticated international trader. In the United States, an investor with as little as $1,000 can purchase shares in a wide range of mutual funds that invest in foreign stock markets. The Japan Fund, for example, purchases shares in the Tokyo market. The issuers of shares purchased by the Japan Fund do not comply with any United States disclosure requirements. Moreover, the Japan Fund invests in shares that trade in a market that does not have the vigorous insider trading and other antifraud protections available in the U.S. Small investors nonetheless decide to purchase shares in the

Japan Fund (and thereby, decide indirectly to purchase shares without U.S. disclosure or trading safeguards) because they believe that the potential benefits available from diversification into the Japanese market outweigh the risks that result from less disclosure and fewer safeguards against fraud. Thus, in an international market, the United States government cannot force even its smallest investors to accept regulatory constraints because the United States government does not force investors to keep their capital at home. Capital leaves the U.S. market for foreign markets whenever the benefits of foreign trading outweigh the risks associated with offshore investing.

Therein lies the reason why regulatory philosophies built on assumptions prevalent in the 1930's are doomed to failure. In a highly internationalized capital market it's difficult to force investors to accept regulations that they do not value. Put a different way, if regulators adopt rules with costs that exceed their benefits, investors will respond by moving their transactions to markets that have regulations that generate a preferable cost-benefit ratio.

The ability to respond to regulatory regimes is certainly greater for some investors than others. At one extreme, there are investors who are able to shift capital among markets with relative ease. At the other extreme stand investors who, for a variety of reasons, are relatively trapped in their domestic markets. Regulators have far more

influence over investors who fall toward the immobile, captive end of the spectrum, than they do over investors whose capital is highly mobile. Internationalization, however, means that an increasing percentage of the world's capital is moving away from the captive end of the spectrum and toward the mobile end.

What's a regulator to do about this situation? One possibility is simply to ignore it and go about the business of regulation as though investors have no choice but to comply. That "business as usual" approach is doomed to failure because it ignores the realities of today's marketplace. A better approach is to rethink the operation of regulation in the international marketplace and recognize that regulation often cannot be forced upon market participants. Regulation must add value that exceeds regulation's cost in order to retain investors in, or attract them to, markets subject to a regulatory regime.

What kind of value can regulation add? Quality. Regulation can increase or decrease the quality of investments and transactions available in any market. Regulation can cause more or less disclosure by issuers. It can make settlement faster or slower. It can forbid or permit many practices that have the effect of shifting various forms of risk among different classes of investors. It can create an environment in which people have confidence that if they sell

they will be paid and if they purchase their securities will be delivered.

Quality, however, comes at a price. Higher quality generally costs more, and in many situations investors will be willing to pay an additional amount to support a regulatory regime that provides valuable quality safeguards. If, however, the level of quality is not one desired by investors, or if the price of quality is too high relative to other alternatives available in the marketplace, then investors will object to the regulation and search out markets that provide better quality-price combinations. Indeed, whenever a regulator undertakes to regulate, the first question that should be asked is, "Where is the market failure? Why is it that a free market left to its own devices will not generate a quality-price level that is at least as preferable as the one that would result from regulation?" Careful analysis may often suggest that a free market will perform at least as well as a regulated market.

Therefore, now that the markets are internationalized, regulators may have to begin thinking of themselves as businessmen who provide a quality control function. There is, in each market, an optimal level of quality that can be attained at a particular price. The task of the regulator is to find the optimal quality-price combination for his market. From this perspective, regulation does not succeed because it is benevolently imposed on market participants. Instead, it

succeeds because it provides a level of quality that investors value and for which they are willing to pay. It succeeds because it passes a cost-benefit test in an international marketplace where investors can pick and choose among a wide array of quality-price combinations. If a regulatory regime cannot pass this market test because its regulations provide quality that is too high or too low, or because its regulations generate a desirable quality level but at too high a price, that regulatory regime will inevitably lose market share to other, more quality-price conscious jurisdictions.

In the world of quality-price competition that is emerging among securities regulators, it is valuable to observe that a single jurisdiction can have more than one quality-price combination. A jurisdiction can achieve this result by having different rules for investors with different characteristics. In particular, it may be politically or economically reasonable for marketplaces to establish levels of protections for transactions involving smaller, less sophisticated investors, that differ from the regulations that apply to transactions involving larger investors with greater sophistication.

The United Kingdom's Securities and Investments Board recently took a significant step in this direction. The SIB determined to permit "business investors" to participate in various financial and commodity markets without being subject to stricter rules that apply to other, less sophisticated

investors. These "business investors" are generally corporations with capital or net assets of at least £ 500,000, local governments, or other public bodies.

Similar steps have been taken in the past in the United States, and more far-reaching measures are under consideration for the future. In particular, the Commission's staff has publicly announced that it is developing a "safe harbor" rule that would permit the resale of foreign and domestic unregistered securities within the United States to institutional purchasers. The rule is being developed in two alternate forms. The first alternative would allow free resale of unregistered securities among "accredited investors" provided that the issuers have been reporting companies in the United States for at least three years, or the security is senior investment grade debt. The second alternative would allow unrestricted resales among large institutional investors. Under this alternative, large institutions would be permitted to buy and sell, in the United States and elsewhere, unregistered securities that would otherwise not qualify for trading.

A separate set of initiatives directed toward much the same goal is emanating from the American Stock Exchange and the over-the-counter market, operated by the National Association of Securities Dealers. Both organizations are actively developing proposals for the creation of "onshore-offshore" marketplaces, markets in which sufficiently large

and sophisticated investors would be able to buy and sell securities in transactions that would otherwise be prohibited.

The evolution of such onshore-offshore markets, or the expansion of the private placement exemptions, does not signal an erosion of regulatory quality or the beginning of a race to the bottom in which all markets deregulate to the level of the lowest common denominator. Instead, the evolution of such marketplaces may actually increase quality by providing a better market for transactions that would occur in any event. Moreover, the evolution of such markets need not lead to an erosion of quality standards applicable to "captive capital" within each market because, by controlling access to an onshore-offshore market, a jurisdiction can regulate the extent to which the onshore-offshore market becomes a substitute for domestic markets.

Thus, the United States market may one day evolve into a multi-tiered market, where certain protections are mandatory in transactions involving smaller investors, and discretionary in transactions involving larger, more sophisticated market participants. I would also not be surprised to see other jurisdictions move in the same direction because even regulators understand that reality can be denied for only so long.

III. Enlightened Cooperation

The third and final point I will make this evening relates to the need for increased international cooperation in

the enforcement of securities laws. As the Guinness and Vaskevitch scandals reveal, violations of securities laws can involve participants from many different jurisdictions. If any jurisdiction is going to do a responsible job of regulating its own markets, it must have the cooperation of its trading partners.

The history of international enforcement cooperation has not always been a smooth one. Many of the difficulties encountered in this area can, I believe, be traced to overambitious plans to create multinational regulatory regimes. They can also be traced to efforts based on the assumption that the United States' trading partners should automatically adopt regulatory principles similar to those used in the United States. Whatever one might think of those initiatives, it seems clear that greater international cooperation could be very helpful. A journey of a thousand miles begins, however, with a single step, and rather than focus on grandiose efforts to create worldwide regulatory regimes--efforts that are likely to be very time consuming and highly political even if they eventually yield fruit--it makes sense, I think, to focus on relatively modest but practical measures that can quickly lead to significant improvements in international enforcement.

The necessary first step is, what I call, a policy of enlightened cooperation. Under a policy of enlightened cooperation each jurisdiction would recognize that it is

illegitimate for anyone to use its marketplace as a haven from which to manipulate other markets. Perhaps the clearest example of how this policy can be applied arose in the United States' investigation of Dennis Levine's trading through a secret Bahamian bank account. The United States Government presented the Bahamian authorities with evidence suggesting that secret Bahamian accounts were being used as a device to shield massive violations of U.S. law by U.S. citizens. The response of the Bahamian authorities was well summed up by Attorney General Adderley who observed that the bank secrecy laws of the Bahamas "were never intended to protect fraud, never intended to protect a thief."

The Attorney General has hit the nail on the head. Different jurisdictions adopt different laws for different reasons. In a linked multinational market it is, however, unseemly at the least for any nation to adopt or apply a regulatory regime for the direct or indirect purpose of shielding violators of foreign laws. I have no interest in seeing British or U.S. subjects, or anyone else for that matter, use the United States as a staging area for the manipulation of British markets or violation of British laws. I would hope that America's trading partners take the same view. Each of us can regulate our own markets as we like. However, as soon as we allow anyone to use our country as a safe haven from which to manipulate the markets of others, we all lose the ability to regulate our own markets.

If we cooperate, we can, together, protect the integrity of our domestic markets and of our domestic regulatory regimes. If we fail to cooperate, none of us will have secure domestic regulatory regimes because each of us will be at the mercy of manipulation from persons trading from outside our limited jurisdictions.

In many ways, the principle of enlightened cooperation is easier to describe than to implement. Each jurisdiction has its own privacy rules, its own rules governing investigations by domestic and foreign investigatory bodies, and its own concerns over the consequences of foreign intrusion--even if that intrusion is in furtherance of what all would concede is a worthy cause. Principles of comity and cooperation must therefore be applied with great respect and deference for the specific circumstances of the jurisdictions involved. An approach that may be appropriate between countries A and B may therefore be unsuitable for countries C and D.

At the Securities and Exchange Commission we have approached this problem by fashioning a series of bilateral treaties or understandings. Each arrangement is designed to provide important information regarding potential violations of the securities laws. Each arrangement is also specifically crafted to respect the local rules and customs of the signatories. In particular:

The United Kingdom Department of Trade and Industry has entered into a Memorandum of Understanding with the Securities

and Exchange Commission that, on a reciprocal basis, provides for assistance in obtaining records held by the respective agencies, or that can be obtained through voluntary cooperation. This is an interim arrangement that both parties see as a first step in efforts to provide greater bilateral cooperation relating to securities regulation. The Memorandum expressly provides for the initiation of further negotiations.

The Memorandum is available for investigations and general market oversight. Specifically, the Memorandum makes assistance available in matters involving insider trading, market manipulation, and misrepresentations relating to market transactions, as well as for efforts relating to the oversight of the operation and financial qualifications of investment businesses and brokerage firms.

The Memorandum also provides special safeguards to ensure that it is not abused by either party. Requests must be made with particularity. When questions arise as to the scope of the Memorandum's operation, consultation between the parties is mandated. Moreover, at the conclusion of the matter in question, and to the extent permitted by law, all documents not previously made public are to be returned to the other authority.

Switzerland and the United States have entered into a Memorandum of Understanding regarding cooperation in matters involving insider trading. In addition, there is a Treaty on Mutual Assistance in Criminal Matters pursuant to which the

Securities and Exchange Commission can obtain information in a broad range of cases where evidence of criminal fraud is apparent.

Canada and the United States have signed a Mutual Assistance Treaty, which is not yet ratified. Letter agreements on cooperation have been entered into with Ontario and Quebec, and negotiations are ongoing with representatives of all provincial governments regarding a comprehensive agreement addressing securities law violations.

Japan and the United States have a Memorandum Agreement between the Securities and Exchange Commission and the Securities Bureau of the Ministry of Finance.

The Netherlands, Turkey, and Italy have all entered into Mutual Assistance Treaties that have been ratified, and the Cayman Islands has signed a Treaty that has not as yet been ratified. Further, with respect to France, negotiations are underway regarding an appropriate cooperation agreement.

The next step in this evolution is, I think, for other nations to embark on a series of negotiations designed to develop appropriate bilateral accords. Slowly but surely, this process of bilateral negotiation can build a web of cooperative arrangements. Such a web will make it increasingly difficult for securities law violators to misuse the mechanisms of the international market.

The speed with which such a network develops depends on many factors. Foremost among them is the perceived need for

such cooperative arrangements. The best advertisement for such arrangements is a good securities scandal with a healthy international angle. For better or worse, the Guinness and Vaskevitch scandals fill that bill quite nicely for Britain. That scandal underscores the advantages Britain can gain from entering into appropriate bilateral arrangements designed to ensure the integrity of Britain's markets by protecting them from foreign manipulation.

Conclusion

In conclusion, it is safe to observe that the world will never be the same again. Though we may wax nostalgic about the good old days when the markets were simpler, slower, and less subject to the forces of internationalization, there is no need to fear for the future. We will not, however, be able to succeed in tomorrow's markets using yesterday's techniques and philosophies. We will not be able to put the genie of technology and internationalization back into the bottle even if we wanted to, and even if such attempts were wise to try. Indeed, nostalgia for the good old days may be our biggest enemy because it can blind us to the realistic nature of the problem that confronts us and lead to a distorted perspective about the feasibility of many solutions.

Instead of looking back, we must look forward. We must recognize and accept the new realities of the marketplace. We must deal with those new realities in a creative, candid, and

credible fashion. We must remember that, if "we would guide by the light of reason, we must let our minds be bold."